financing the canada pension plan

a report by the
national council of welfare

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Canada

F I N A N C I N G   T H E
C A N A D A   P E N S I O N   P L A N

One in a Series of Reports
by the National Council of Welfare
on Canada's Retirement Income System

December 1982

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FOREWORD

A retirement income system should perform two essential tasks. The first is to ensure that all elderly persons are assured a minimum income which will enable them to live decently and in dignity, no matter what their circumstances in their working years. The second is to maintain a reasonable relationship between an individual's income before and after retirement so that old age does not bring a drastic reduction in his or her standard of living.

Canada's pension system, unfortunately, neither prevents poverty among the elderly nor adequately replaces pre-retirement income. Sixty percent of single people 65 and older - the majority of them women - live below the poverty line. Half of the aged population - over 1.2 million men and women - have so little income they qualify for the Guaranteed Income Supplement, an anti-poverty program originally intended to serve what was supposed to have been a shrinking minority of impoverished pensioners. Large numbers of Canadians who are middle-income earners during their working years undergo a serious drop in income after they retire. The gap between the haves and have-nots yawns wide among the elderly: a minority enjoy comfortable retirement incomes from savings, investments and private pension plans, while the majority have to get by on low or modest incomes obtained mainly from government programs.

Economic and social forces are exerting mounting pressure on our already weak retirement income system. Inflation eats away at private pension credits earned by workers and payments received by pensioners. The aged are increasing much faster than the population as a whole, and the rate of growth is especially rapid among elderly women and persons 70 to 80 years old. Projections indicate that the elderly, who at 2.4 million currently account for one in ten Canadians, will increase to 3.4 million or 12 percent of the population by 2001 and 6.2 million or two persons in ten by the year 2031.

These facts have by no means gone unnoticed. In April of 1981 a National Pensions Conference, attended by delegates from industry, labor and government as well as women's and pensioners' groups, concluded that Canada's pension system urgently demands a major overhaul. In December of 1982 Ottawa released a green paper on pension reform, Better Pensions for Canadians. The report presents a number of proposals for reform

which will be referred to a parliamentary committee for a year's study and public response. Over the past few years there has been a steady stream of studies, briefs and proposals on the retirement income system.

Pension reform is a complicated subject, even for the specialist. Canada's retirement income system is comprised of three major levels and, within each level, several elements - a foundation of federal and provincial income security programs; a second tier of public pension plans (the Canada Pension Plan and Quebec Pension Plan); and a third layer of private pension plans of varying design, Registered Retirement Savings Plans, and special tax provisions that encourage saving for retirement and lower taxes for the elderly. Most people have only a vague idea of how this complex system operates, let alone understand what is wrong with it and what can be done to set it right. Yet the outcome of the pension reform process will touch every Canadian who pays taxes, contributes to pension plans and reaches the age of retirement.

The report that follows is one of a series of papers by the National Council of Welfare on the retirement income system. The purpose of the series is to provide the basic facts which the ordinary Canadian needs to participate in the pension debate. Each report explains a major element of the retirement income system, discusses its strengths and weaknesses, and recommends reforms.

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INTRODUCTION

Few aspects of government operation are as poorly understood - indeed, so often totally misunderstood - as the financing of the Canada Pension Plan. Myths and misconceptions abound. With almost predictable regularity there are alarmist accusations that the Canada Pension Plan is going broke, that Canada Pension Plan funds are being given away to the provinces at little or no interest, and that a frightening cost burden is being passed on to future generations.

None of these charges is true. They are all born of a lack of understanding of how the Canada Pension Plan (CPP) is really financed. In turn, this lack of understanding is rooted in the false notion that CPP financing is so complex as to be beyond the comprehension of most people.

While CPP financing is admittedly not simple, it is also not so complicated that the average Canadian cannot understand the basic principles by which it operates. And it is essential that Canadians do understand these principles if they are to participate effectively in the important debate which has been going on for several years, and which will reach a critical stage during the next few months, over the reform of our pension system.

The most fundamental question in the pension debate is the extent to which the Canada Pension Plan, and the counterpart Quebec Pension Plan, should be expanded to guarantee Canadians a greater income in retirement. While many issues must be resolved in answering this crucial question, the key ones revolve around costs and financing. Unless we understand

the present financing and the eventual costs of the Plans which already exist, we will lack an essential element in deciding what size of expansion Canada needs and can afford.

This report looks at the financing of the Canada Pension Plan. It describes how the financing system works and tries to correct some of the most common misconceptions. It also looks at the issues which the federal and provincial governments will be addressing over the next couple of years about the future financing of the CPP. Finally, it suggests certain principles which should guide governments in their deliberations.

As its title suggests, this report focusses on the Canada Pension Plan. While the Canada and Quebec Pension Plans are almost identical in terms of the benefits they provide and certain aspects of their financing systems, other parts of their financing are quite different. We will describe the most important of these differences. For those aspects of financing in which the Canada and Quebec Pension Plans are similar, the National Council of Welfare hopes that the recommendations in this report will be considered in regards to the Quebec Pension Plan. However, we will not attempt to make recommendations on those aspects of financing which are unique to the Quebec Pension Plan and which fall entirely within the jurisdiction of the Government of Quebec.

CPP FINANCING: THE FIRST TWO DECADES

Under Canada's constitution, jurisdiction for pensions is divided between the federal and the provincial governments. In regards to public pension plans, the constitution says that Ottawa can enact legislation establishing such plans provided the federal legislation does not affect the operation of a similar provincial program.[1]

Although the courts have never been asked to give a legal interpretation of this section of the constitution, it is generally taken to mean that any province which so chooses can opt out of a federally legislated public pension plan if it sets up a comparable program of its own. This is precisely what happened in the 1960's when the Canada Pension Plan was enacted and Quebec decided to establish the Quebec Pension Plan.

Two important practical considerations follow from the constitutional provisions concerning public pension plans. The first is that a federally legislated program, if it is to have real effect, must have the approval of a significant number of provinces with a substantial part of the Canadian population. Otherwise, no matter how good the plan might be, it would not mean much because it would not apply to many people.

The second consideration arises if the federal government legislates a plan and a province chooses to opt out and set up another plan of its own. To the extent possible, it is desirable for the two plans to be similar in their level of benefits and rates of contributions. Otherwise a serious

barrier to the movement of labor between provinces could develop, and the costs of doing business might be appreciably different from one part of Canada to another. This concept is often referred to as parallelism.

The desire to maintain a high degree of parallelism between the Canada and Quebec Pension Plans, and the need to ensure that the other nine provinces would participate in the Canada Pension Plan, were critical elements in designing the CPP and QPP in the early and mid-1960's. This was particularly the case in the decisions regarding the financing of the Canada Pension Plan.

The federal government preferred the Plan to be financed on a "pay-as-you-go" basis. Pay-as-you-go means collecting just enough money each year through contributions to cover the administrative costs and the benefits that are paid out that year. Such a financing method keeps contributions as low as possible during the early years of a public pension plan, and does not accumulate money in a fund (since the contributions that come in from members of the work force are paid out immediately to pensioners).

Quebec, on the other hand, wanted a higher contribution rate during the early years of the Quebec Pension Plan. As part of its economic development strategy at that time, the provincial government wanted to create a fund which could serve as a pool of money available for investment in public and private projects in Quebec.

In order to maintain parallelism, a compromise was struck. It was agreed that the Canada and Quebec Pension Plans would start with a contribution rate of 3.6 percent - half to

be paid by an employee and half by his/her employer.[2] This was considerably higher than the pay-as-you-go rate that would have been required at the start of the new Plans, but less than the rate which Quebec had originally proposed.

One fact should be emphasized. It was fully realized that the 3.6 percent contribution rate was far short of what would have been needed if the Plans were to be fully-funded - i.e. if, like private pension plans, enough money were put aside each year for investment to build a fund out of which all the pensions that had been earned up to that year could eventually be paid. Thus the designers of the Plans, and the legislators who enacted them, knew that at some time in the future the contribution rate would have to be increased.[3]

However, for the first fifteen or twenty years of the Plans, the 3.6 percent rate would generate far more revenues than would be needed to pay for benefits and administration. Over this period, therefore, a fund would be accumulated. Such a financing system is known as partial funding.

In keeping with its economic development objectives, Quebec decided that the surplus funds in the Quebec Pension Plan would be deposited with an independent agency of the provincial government (the Caisse de dépôt et de placement) which would invest the money in corporate stocks and bonds, mortgages, provincial securities and other such vehicles. For the Canada Pension Plan, however, the issue of what to do with the surplus funds was more difficult because there were two levels of government - the provinces and the federal government - which had some claim to this money.

In the end, as a critical part of the complex deal through which the nine provinces participated in the Canada Pension Plan, it was agreed that the surplus money in the Canada Pension Plan Account[4] (other than an operating reserve to pay for expenses during a three-month period) would mostly be loaned to the provinces.[5] Many believe that this provision was the deciding factor in getting the provinces to participate in the Canada Pension Plan, and so was essential for making an effective program possible.

In apportioning the surplus among the provinces, it was agreed that each would be allowed to borrow an amount proportional to the contributions paid by the residents of that province. (For example, if 15 percent of all contributions in a certain period come from residents of British Columbia, then the B.C. government can borrow 15 percent of the surplus). The part of the surplus proportional to contributions from residents of the Yukon and Northwest Territories, and any other amounts that might remain, must be borrowed by the federal government. Table 1 shows the total borrowing by each province and the federal government as of October 31, 1982.[6]

TABLE 1

CANADA PENSION PLAN LOANS AS AT OCTOBER 31, 1982

($,000)

Newfoundland	-	$ 460,783
Prince Edward Island	-	95,519
Nova Scotia	-	881,284
New Brunswick	-	664,727
Quebec[7]	-	98,009
Ontario	-	12,027,326
Manitoba	-	1,284,073
Saskatchewan	-	1,001,992
Alberta	-	2,367,874
British Columbia	-	3,352,467
Federal government	-	167,573
TOTAL		$ 22,401,627

One thing should be stressed at this point. The loans to the provinces[8] from the Canada Pension Plan are real loans. Provinces must issue securities for all the money which they borrow, and these securities can be redeemed on six months' notice by the Minister of Finance whenever the money is needed to pay for benefits or other costs of the Canada Pension Plan. Contrary to what is often charged, the money is not being given away - certainly not under the terms of the legislation as it is now written.

Moreover, as with any loan, the borrowers (the provinces) must pay interest. In fact, next to contributions from employees and employers, interest payments from provincial governments are the second major source of revenue for the Canada Pension Plan.

One of the most common myths about the Canada Pension Plan is that the interest charged to provincial governments is extremely low. This is not the case, although it is true that provinces are charged less than the full market rate.

Interest on loans from the Canada Pension Plan is set at the same rate as that on long-term Government of Canada securities. For loans made in September 1982, for example, the rate was 15.54 percent. In late 1981, when interest rates in general were very high, the CPP borrowing rate reached 17.51 percent.

The notion that the provinces are borrowing money from the CPP at bargain-basement rates stems from the fact that the interest which they are charged for their CPP loans is lower than what they would have to pay to borrow money from other sources.[9] This is the case because the provinces, generally, have to pay higher interest on their borrowing than the federal government. The interest "reduction" varies from half a percent for the wealthiest provinces to several percentage points for some of the poorer provinces. As a result, the interest formula for CPP loans has an element of redistribution since the poorer provinces derive the greatest relative benefits from this source of funds.

Another common misconception about Canada Pension Plan financing is that the provinces do not really pay the interest at all. Again, the facts speak otherwise.

Because contributions from employees and employers have exceeded expenditures (benefits and administrative costs) each year since the Canada Pension Plan began, it has never been necessary to use the revenues from interest in order to

cover the CPP's expenses. Provinces pay interest in the sense that interest charges are added to what each province owes to the Canada Pension Plan fund. However, there is no actual net transfer of cash between the provincial treasuries and the CPP because the interest that a province pays is, in effect, immediately loaned back to that province as part of its share of the surplus in the Canada Pension Plan Account.

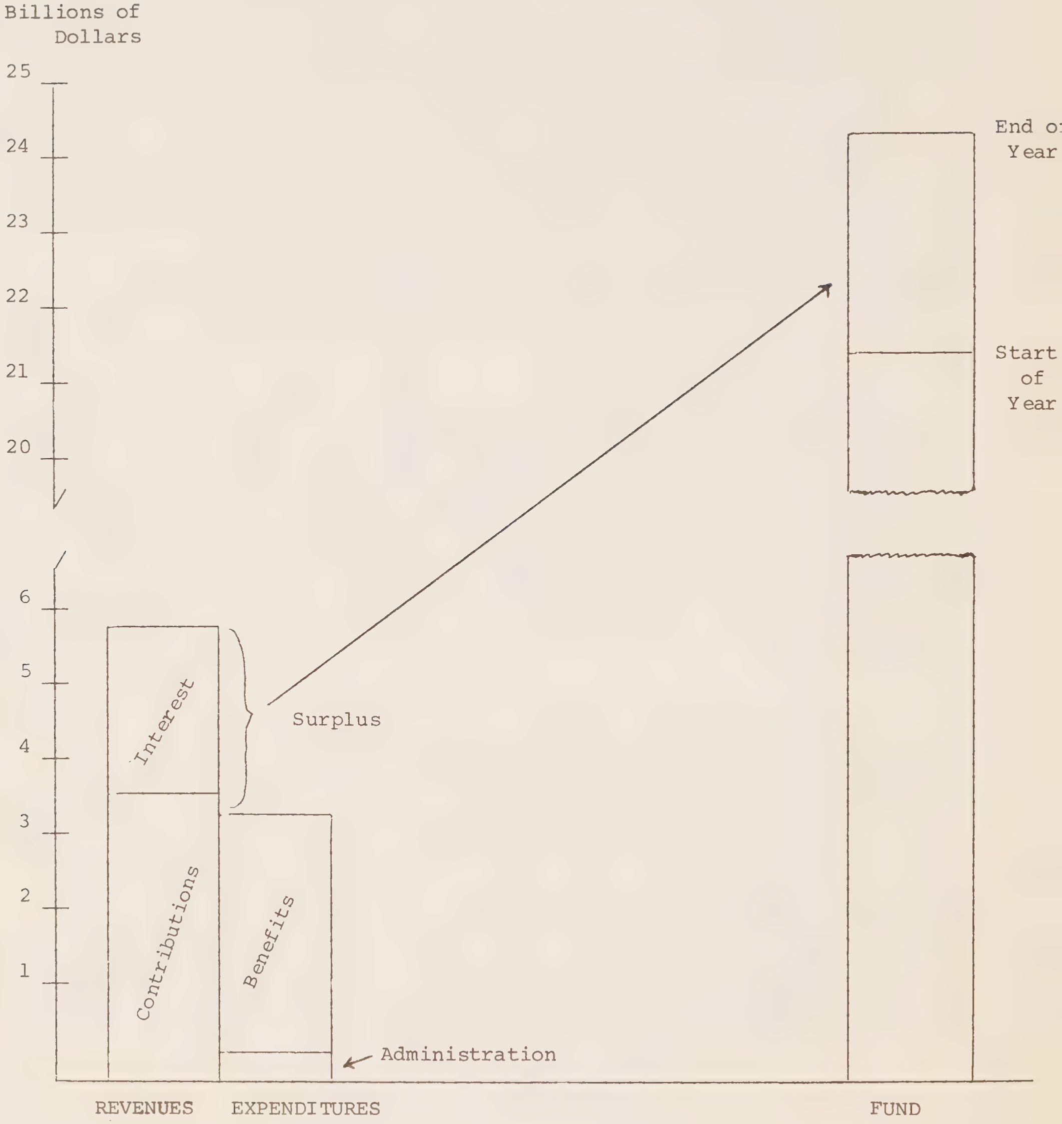
The discussion so far has been fairly abstract. Some concrete figures might be helpful. Figure 1 shows the expected revenues and expenditures of the Canada Pension Plan in the current (1982-83) fiscal year, as well as the amount of money credited to the CPP Account at the beginning and end of the year.[10]

On April 1, 1982, the Canada Pension Plan Account had a balance of approximately $21.5 billion. Of this, $20.5 billion was on loan to the provinces, and $1.0 billion was being retained as an operating reserve (as required by law) to cover expenditures during the first three months of the fiscal year. (The federal government, by the way, pays interest on the operating reserve).

Revenues during 1982-83 are expected to total $5.8 billion - $3.6 billion in contributions and $2.2 billion from interest. Expenditures are forecast at $3.1 billion - $3.0 billion for benefit payments and $86.2 million for administrative costs. The $2.7 billion by which revenues exceed expenditures will be put into the Canada Pension Plan Account and loaned to the provinces (except, again, for the portion retained for the operating reserve). The balance in the Account at the end of the fiscal year will be approximately $24.3 billion.

FIGURE 1

CANADA PENSION PLAN FINANCING
1982-83 FISCAL YEAR



As for the Quebec Pension Plan, the accumulated fund on April 1, 1982, stood at just under $8 billion.[11] In the 1981-82 fiscal year, the QPP had revenues of $1,842 million - $1,040 million from contributions and $802 million from investment income (i.e. dividends from its portfolio of stocks and bonds, interest on provincial securities, and so on). Its expenditures were $901 million - $864 million in benefit payments and $37 million in administrative costs. By the end of the current (1982-83) fiscal year, the Quebec Pension Plan fund will exceed $9 billion.

CPP FINANCING: THE NEXT TWO DECADES

While contributions to the Canada and Quebec Pension Plans will exceed expenditures by very sizeable amounts in the current fiscal year, this situation will not last much longer. Benefit payments are increasing rapidly as more and more persons who have contributed to the Plans retire and begin to draw retirement benefits. And the increase in total benefit payments is growing faster than the increase in contributions.

There will soon be a milestone in the history of the Canada and Quebec Pension Plans when expenditures will exceed contributions (assuming that the contribution rate remains at the current 3.6 percent). This point is often termed "critical year 1". According to the actuarial projections,* critical year 1 will be in 1985 for the Canada Pension Plan[12] and 1986 for the Quebec Pension Plan.[13]

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* The most recent comprehensive actuarial report from the Department of Insurance was published in 1978. It was based on what were thought, at that time, to be reasonable assumptions about future employment levels, inflation rates and interest rates. Because of the sharp increase in unemployment in the past year combined with continuing high inflation, it is quite possible that CPP/QPP revenues will be significantly lower than expected and that the total cost of benefits will be higher. This has certainly been the case in the United States in regards to their social security system. In Canada, the most important consequence for the CPP and QPP may be that "critical year 1" will occur earlier than forecast. If this happens, political pressures to 'solve' the CPP financing issue might be increased, but the situation would not be changed in any significant way from what is described in this report. The next comprehensive actuarial report is due in early 1983.

Actually, 1985 will be critical only from the point of view of provincial treasuries, because it will be the first year in which some of the revenues from the interest paid by the provinces to the CPP will be needed to cover expenditures. In other words, there will be an actual net flow of cash from provincial treasuries to the Canada Pension Plan. In all other respects, the CPP and the QPP will continue to operate as before.

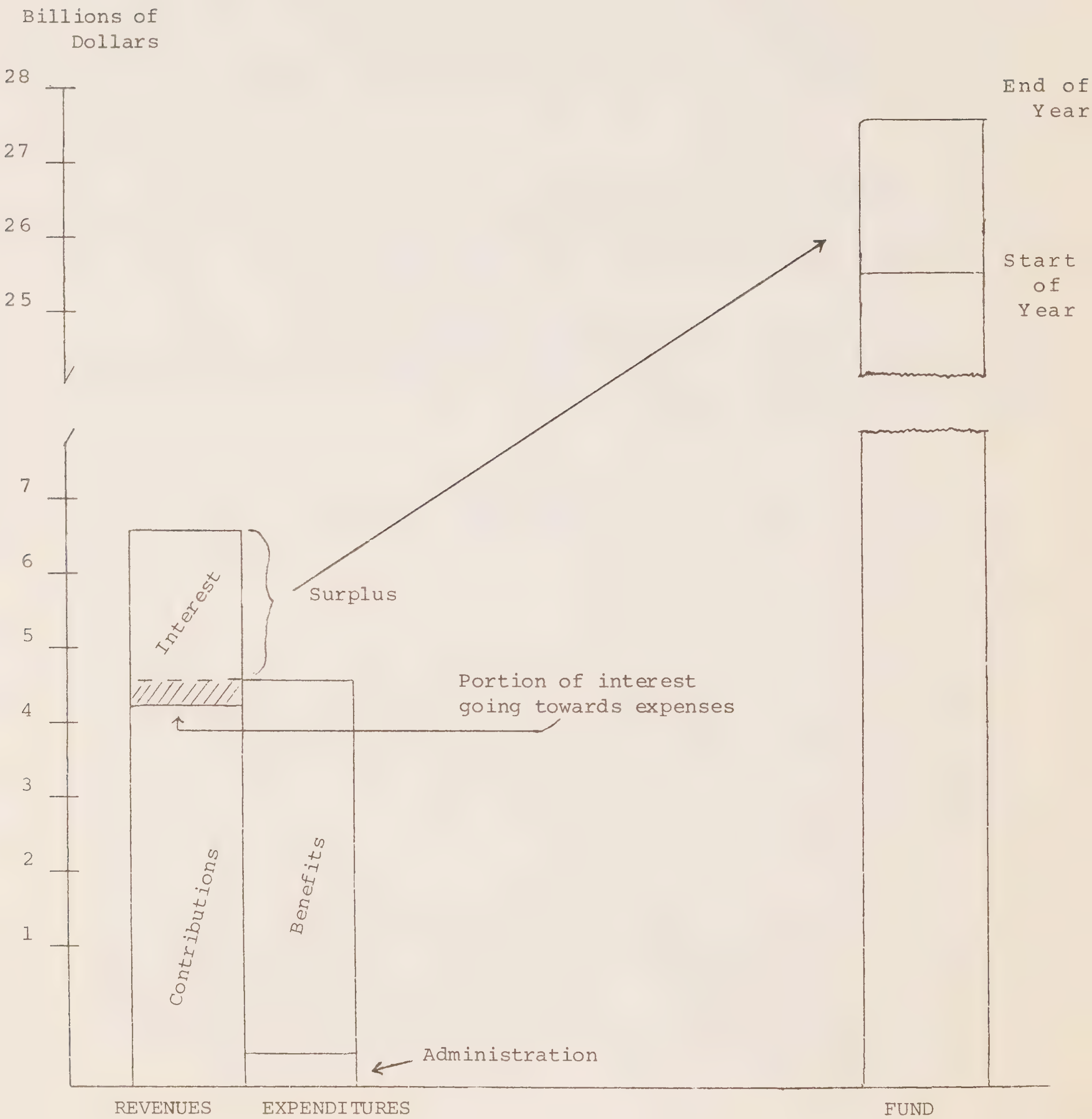
The flow of money from the provinces to the Canada Pension Plan will be small at first since not all the interest from previous years' loans will be needed immediately. For a few years, then, there will still be some "surplus" interest to be borrowed from the Canada Pension Plan Account, and the fund will continue to grow. Figure 2 illustrates the situation which is expected to apply in 1985.[14]

It is estimated that CPP benefit payments and administrative costs will come to $4,415 million in 1985. Contributions, however, are estimated at only $4,372 million. Therefore $43 million in interest payments will be needed to cover the shortfall. This is only a small part of the almost $2 billion in interest which will be due that year; the remainder, an estimated $1.9 billion, will go into the Canada Pension Plan Account and will be loaned back to the provinces. As a result, the fund will still increase in 1985, growing from $25.6 billion to $27.5 billion.

Although the flow of money from the provincial treasuries to the Canada Pension Plan will be small in 1985, it will increase rapidly in each succeeding year. In 1986, for instance, the flow is estimated to reach $300 million and, by 1990, almost $1.7 billion.

FIGURE 2

CANADA PENSION PLAN FINANCING
1985 - "CRITICAL YEAR 1"



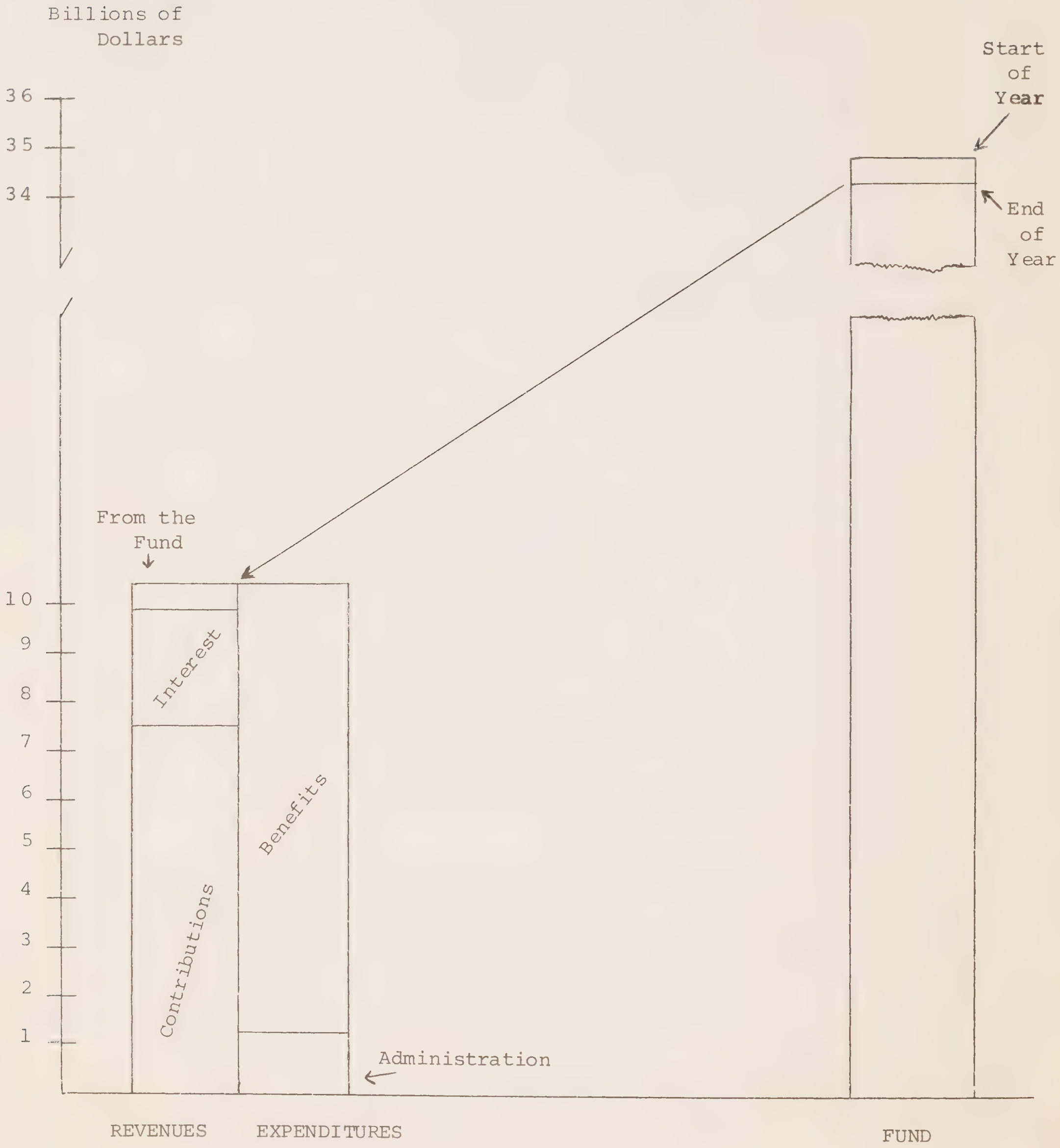
Finally, in 1993, the Canada and Quebec Pension Plans will reach the point where even full interest payments (or, in the case of the QPP, full investment earnings) plus contributions at 3.6 percent will not be enough to cover expenditures. This is referred to as "critical year 2". If by this point governments have not acted to raise the contribution rate, the shortfall between expenditures and revenues will have to come out of the Investment Fund. What this means, of course, is that the provinces will have to start repaying the principal on their loans from the CPP. (In the Quebec Pension Plan, the investment portfolio will have to start being cashed in). Figure 3 illustrates the situation expected in 1993.

Because of the large amount of money that will be accumulated in the CPP and QPP funds by 1992 - a projected $34.7 billion in the CPP and $15.5 billion in the QPP - repayment of the principal would be sufficient to keep the Canada and Quebec Pension Plans solvent for another decade, even with a contribution rate that remained at 3.6 percent. But an end finally would come - "critical year 3" (2003 for the CPP and 2002 for the QPP) - when the funds would be exhausted. After critical year 3, the contribution rate must go up or the Plans will not be able to continue operating. This fact is what has given rise to the fanciful doomsday scenario of an "impending bankruptcy" of the Canada and Quebec Pension Plans.

We cannot emphasize strongly enough that this "bankruptcy" is a purely theoretical situation. It will never happen. Governments will have acted far in advance to increase the contribution rates in order to assure the revenues needed to pay for all the future Canada and Quebec Pension Plan benefits which come due.

FIGURE 3

CANADA PENSION PLAN FINANCING
1993 - "CRITICAL YEAR 2"



The important questions now are: How much should the contribution rates be raised? When should this increase occur? How should it be phased in? Should there continue to be a year-to-year surplus? If so, what should it be used for?

These are all questions which are under intensive study by the federal and provincial governments. They are questions that probably will be answered over the next few years in the course of federal-provincial negotiations, and the answers may be only partially based on pension criteria.

As the preceding discussion has shown, the Canada Pension Plan is a major source of provincial borrowing. The importance of this source can be illustrated by taking one example - the province of Ontario. According to the most recent provincial budget, Ontario will have a deficit this fiscal year of $2.2 billion. Of this amount, over half - $1.2 billion - will be financed by the loans from the Canada Pension Plan.[15]

With this much money involved, it is understandable that the provinces have a keen interest in the future financing of the Canada Pension Plan. Their concern is combined with an important say in what changes will be made to the financing system.

As part of the arrangement by which the provinces agreed to participate in the Canada Pension Plan, a unique "amending formula" was built into the legislation. Although the Canada Pension Plan is an act of the federal Parliament, key aspects of the Plan such as the contribution rate and the level of benefits can only take effect if they are approved both by Parliament and by two-thirds of the provinces with two-thirds

of the population of Canada.[16] Thus any four provinces can block a change to the financing system, and Ontario - where more than one-third of Canadians live - has an effective veto over any change to the Plan.

Inevitably, then, questions of provincial financing will loom large in the federal-provincial negotiations over Canada Pension Plan financing. The public interest demands that the issues of provincial financing not be allowed to dominate these negotiations nor become the major factor in deciding the outcome.

FUTURE FINANCING OF THE CPP: WHAT NEEDS TO BE DONE?

Two fundamental goals underlie the financing systems of all pension plans, whether private (employer-sponsored) plans or publicly administered programs. The first is to ensure that the pensions which are promised will, indeed, be paid; in other words, that the money will be available when it is needed. The second is to keep the costs of the promised pensions as low as possible while, at the same time, allocating those costs fairly among current and future contributors to the plans.

In private plans these two objectives are met by requiring full funding. Any private company, no matter how large or apparently affluent at one point in time, could encounter financial difficulties or even bankruptcy in the future. If the pensions promised by a company are to be truly secure, sufficient money has to be put aside in an investment fund each year to pay for the part of the future pensions related to that year's service. Moreover, under such a system of advance funding, current contributors themselves (with the help of their employers) are paying for their own eventual pensions, so the question of fairness vis-à-vis future plan members is automatically settled.

It is sometimes suggested that a similar system of full funding should be implemented for the Canada Pension Plan. Proponents of this proposal (who, not coincidentally, are usually strongly opposed to public pension programs in general) argue that only full funding of the CPP can guarantee security of future benefits. They frequently mix their calls for full funding with charges that the CPP is going bankrupt or, at the

least, that a staggering liability is being passed on to future generations.

Having just seen that no such "bankruptcy" is going to happen, it is not necessary to comment further about this. But what about the argument regarding security of benefits? What truth is there to it? And what truth is there to the charge that future members of the work force will have to bear a tremendous cost burden if we fail to switch to full funding?

A fully funded Canada Pension Plan would rapidly lead to an enormous accumulation of money. For example, according to estimates by the Ontario Royal Commission on Pensions,[17] if the CPP had been converted to a fully funded system starting in 1980, a fund of over $700 billion would build up by the end of the century, and this would grow to just under $9 trillion (thousand million) by 2030.[18] While it might be theoretically possible to conceive of governments using this money to buy up large parts of what is now the private sector, in practical terms such a radical shift in economic policy is unimaginable. Anyway, it would be counter-productive since such a policy of nationalization would almost certainly precipitate panic in stock markets and an enormous decline in share prices, thus drastically eroding the value of the fund itself.

An alternative would be to invest the money primarily in new ventures in the private sector, perhaps as a source of risk capital for small and medium-sized enterprises or perhaps as a way of financing the mega-projects of the future. However, as the Ontario Royal Commission concluded, the volume of money generated by a fully funded CPP would far exceed any reasonable expectation of private sector capital requirements in the

foreseeable future.[19] Some of the money could go to the private sector, but it does not appear realistic to think that the private sector could absorb it all. A large part would remain which could only be invested through loans to governments. To secure these loans, governments would issue bonds. However, government bonds are only as good as the ability of governments to raise money through taxation. And it is precisely this power to raise money through taxation (or mandatory contributions) that makes an unfunded pay-as-you-go public pension plan possible.

In the end, a fully funded public plan is not one bit more secure than a pay-as-you-go plan. The argument that a public pension program must be financed like a private plan to guarantee security of benefits is rooted in two hypotheses: either that the program's sponsor - the government - could go bankrupt, or that the future government could decide to renege on today's promise and reduce benefits. But if the government were to go bankrupt, no amount of advance funding would provide security; bonds, whether public or private, would be worthless. There is no protection against a hypothetical government bankruptcy which is, anyway, too absurd a scenario to be seriously contemplated.

As for the possibility of a future government reneging by reducing benefits, nothing can absolutely guarantee against this - not even a fully-funded plan. (After all, what would absolutely guarantee that a future government would not divert the money in such an enormous fund for other purposes and refuse to make it available to pay pensions?) There simply has to be some basic trust that future governments will stand by the commitments that have been made to Canadians.

If full funding of the CPP does not provide more security than pay-as-you-go financing, perhaps it might be defended on the basis of significantly lower cost. The evidence, however, is to the contrary. The actuarial projections from the Department of Insurance indicate that putting the CPP on a fully funded basis would require an immediate rise in the contribution rate from the current 3.6 percent to between 8 and 9.4 percent. A pay-as-you-go system would not reach this level until well into the twenty-first century, and after that the pay-as-you-go rate would not exceed the full funding rate by more than 1 percent. The Ontario Royal Commission, which used a different calculating method, concluded that the full funding rate would always be higher than the pay-as-you-go rate.

Full funding would never be appreciably cheaper than pay-as-you-go, and might always be more expensive. Therefore no staggering liability is being passed on to future generations by not putting the CPP on a fully funded basis. This is just another of the myths.

There is no reason for fully funding the Canada Pension Plan. The dilemma of what to do with the vast amounts of money that would accumulate, the shock to the economy of having to immediately more than double the contribution rate, and the fact that there would be neither greater security of benefits nor lower costs should all combine to put such proposals permanently to rest.

The only fund which a public pension scheme such as the CPP requires is a relatively small contingency reserve which can protect against unexpected fluctuations in revenues or expenditures. Such a reserve removes the need to make sudden adjustments to the contribution rate in the event, for instance,

that an unexpected increase in inflation drives up costs or a rapid rise in unemployment causes revenues from contributions to fall. It is often suggested that the contingency reserve should equal two years' benefits.

Other than this contingency reserve, the Canada Pension Plan should be financed on a pay-as-you-go basis. Benefits would be entirely secure because they would be backed by the power of government to raise the necessary money through contributions; costs would be kept as low as possible; and future members of the work force would not be asked to bear an unreasonable burden.

Since, as we have already seen, the current contribution rate generates more revenues than are needed to cover expenditures at the present time, the next important question is <u>when</u> the switch to pay-as-you-go should take place. There are three basic possibilities, and these coincide with the three "critical years" of the CPP.

The first option would be to put the CPP on a pay-as-you-go basis in 1985, "critical year 1", when CPP expenditures will first exceed revenues from contributions at the current 3.6 percent rate and provinces would have to start making net interest payments to the Plan. By increasing the contribution rate to 3.64 percent in 1985, and with further small rises in subsequent years so that the rate would eventually reach 9.09 percent in 2030, revenues from contributions could be kept permanently equal to expenditures, and net payments from provincial treasuries would never be required. As is now the case, provinces would still pay interest in the sense that what they owe in interest would be added to their total CPP borrowing. But this would become a purely "paper" transaction.

In practical terms, the interest would really be "forgiven" since the financing system would ensure that net payments would never have to be made.

A second option for switching to pay-as-you-go would be to wait for 1993, "critical year 2", when CPP expenditures would first exceed revenues from contributions at the current 3.6 percent rate plus net provincial interest payments, and the principal of the CPP fund would have to start being run down. Under this option, the 3.6 percent contribution rate could be retained for another decade, after which it would start to be slowly increased; by 1995, for example, it would have to be 4.13 percent and by 2030 it would be 8.98 percent. Provinces would really be required to pay full net interest on their previous borrowing from the CPP. The principal, however, would not be repaid; it would remain as a contingency reserve of about $35 billion.

The final option would be to wait until 2003, "critical year 3", when the fund would be exhausted. Under this option, the 3.6 percent contribution rate could be kept for another thirty years and would then have to be increased in one step to around 6 percent. Provinces would not only have to pay full net interest on previous borrowing, but they would have to repay the principal as well. In the end, the plan would be left with no contingency reserve.

This third option should be immediately dismissed. As we have already discussed, some contingency reserve is needed to iron out short-term fluctuations in revenues and expenditures. The choice, then, is really between the first two options.

Provincial governments evidently will prefer the first option. It would clearly be to the provinces' advantage not

to have to make net interest payments to the CPP, and they will argue vigorously for a financing system that ensures this will never be the case.

In defending their position, provinces may say that there is no point in asking provincial residents, in their capacity as taxpayers, to pay interest to themselves in their capacity as CPP contributors. This argument, however, evades an important consideration of equity. CPP contributions fall most heavily on lower and middle-income wage-earners - those making less than the maximum pensionable earnings - all of whose income (except for a small exemption) is subject to CPP contributions. General provincial taxes, on the other hand, are more progressive; they apply to income in all amounts and from all sources, particularly non-wage income which accrues primarily to higher-income persons. Thus, asking provincial taxpayers in general to pay for the interest on CPP borrowing is far more equitable than asking CPP contributors alone to pay for it.

Of course, some provinces may not be satisfied with only having previous interest forgiven. They may argue for a contribution rate in excess of what is required for pay-as-you-go. This would not only get them out of net interest payments but could even make additional borrowing from the CPP possible. If the latter is deemed politically unacceptable, it might be proposed that the "new surplus" should go for investment in the private sector.

Increasing the contribution rate above the pay-as-you-go level just to give provinces new money to borrow should be dismissed out of hand. There is no reason whatsoever for asking CPP contributors to continue to finance provincial deficits.

If provinces need to borrow money, they should do so in the usual capital markets, and the costs of the borrowing should be borne by all taxpayers through general taxation. The CPP was designed to be a pension plan, not a vehicle for general provincial financing. Considerations related to the latter will always threaten to distort the purpose of the plan. The CPP should be extracted from the business of provincial financing; it should certainly not get further into it by making additional money available to the provinces for borrowing.

A similar argument applies to proposals to use the CPP to create a pool of money for investment in the private sector. Admittedly, risk capital is often difficult to obtain in Canada, and many worthwhile economic ventures might be possible if additional investment funds were available. However, why should the Canada Pension Plan be used for these purposes? The CPP, after all, is a social insurance program designed to protect Canadians against the contingencies of retirement, disability and death. These social goals should be kept foremost and should not be muddled with other unrelated objectives. There may well be a case for creating a new investment vehicle financed out of public money to encourage economic development or provide risk capital, but this should be done out of general government funds, not linked in an artificial way to the Canada Pension Plan.

A fundamental principle in deciding on the future financing of the Canada Pension Plan should be to remove considerations that are unrelated to the CPP's basic role as a social insurance program. As an application of this principle, the relevant question to be asked about provincial interest payments on past loans is whether there is any pension-related reason for forgiving those payments. The answer is that there is none.

Therefore provincial governments should make net interest payments on CPP loans when this money is needed to cover CPP expenditures. To do otherwise would both violate the principle just discussed and undermine public confidence in the financing of the Canada Pension Plan. It would give reality to what, so far, have been only myths about CPP financing. The money was loaned to the provinces in good faith, and under the terms of a contract; interest should be paid by the provinces, just as they promised in that contract.

The contribution rate for the Canada Pension Plan should remain at the current 3.6 percent level until full net provincial interest on past loans is being paid to the CPP (i.e., "critical year 2"). If CPP benefits are kept at their current levels, this is not expected to happen until 1993. Of course, if CPP benefits are increased, "critical year 2" will happen earlier.

Thereafter, there should be an automatic mechanism for ensuring increases in the contribution rate to keep pace with rises in expenditures. This mechanism should not require legislation by Parliament and the concurrence of two-thirds of the provinces with two-thirds of the population of Canada to implement each increase. (Of course, this mechanism itself would have to be enacted using this amendment formula of the CPP). One possibility would be to review the contribution rate every five years on the basis of the actuarial projections of expenditures and revenues. The federal government would be empowered to adjust the annual contribution rate for each of the five years as indicated necessary by this review.

Combined with a contingency reserve to iron out unexpected fluctuations, this type of mechanism should ensure a stable system of financing with predictable costs for both employers and employees. The Canada Pension Plan will be kept on a solid financial footing that will protect today's workers and retired as well as generations to come.

FOOTNOTES

1. Constitution Acts, 1867-1982, Section 94A (formerly Section 94A of the British North America Act).

2. A self-employed person pays the full 3.6 percent.

3. It is worth noting that the 1964 actuarial report forecasted a scenario whereby the 3.6 percent contribution rate would provide for a fund until around the turn of the century, which is not different than current expectations.

4. The legislation establishing the Canada Pension Plan orders the creation of a special account which is titled the Canada Pension Plan Account (R.S.C., c.C-5, sec. 110). All the revenues of the CPP (e.g., from contributions and from provincial interest payments) are credited to this Account, and all expenditures of the Plan (e.g., for benefits and administrative costs) are charged to this Account. The balance in the CPP Account, therefore, is the accumulated surplus of the CPP; this is what is often referred to as the "CPP Fund". No payment related to the CPP can be made unless there are sufficient amounts credited to the CPP Account to cover it. Put in slightly different terms, CPP expenses can only be paid from CPP revenues; general tax revenues cannot be used.

5. For accounting purposes, the loans are charged to another special account known as the Canada Pension Plan Investment Fund which is also mandated by the CPP act (sec. 111). The amount credited to the Investment Fund (that is, the amount on loan in any given month) is the same as the amount credited to the Canada Pension Plan Account for that month less an "operating balance" equal to the estimated expenditures in the following three months.

6. Canada, Health and Welfare Canada. Canada Pension Plan Account Monthly Report for October 1982 (Ottawa: 1982), Schedule F.

7. While almost everyone working in Quebec contributes to the Quebec Pension Plan and not the Canada Pension Plan, there are some persons in Quebec who are covered by the CPP; these include members of the Armed Forces and the Royal Canadian Mounted Police. The loans to Quebec from the CPP arise from their contributions.

8. To simplify terminology, the rest of the report will refer simply to the "loans to the provinces" since these make up 99.3 percent of all CPP loans. However a small part of the CPP borrowing (under 1 percent) is by the federal government.

9. An additional source of the misconception about CPP interest rates stems from references to "average" interest rates. Loans from the CPP are secured by 20-year bonds; in other words, once money is loaned in any given month, the interest on that month's borrowing will stay the same for 20 years. As any Canadian knows, interest rates have risen dramatically in the last few years. Much of the CPP fund, however, was loaned before these high rates came into effect, and so is secured by bonds with relatively low interest charges. The very first loans from the CPP made in March 1966, for example, only charged interest at 5.29 percent, which at the time was not unreasonable for long-term government securities; the bonds which secure these first loans will not mature until 1986. Thus, the average interest on all loans since 1966 is much lower than the interest on current loans. In September 1982, for instance, the average rate was 10.08 percent while the current rate was 15.54 percent. It should be noted that if interest rates decline in the future, the present situation will reverse, and the average rate will be higher than what will be charged at that time for current borrowing.

10. For data on anticipated CPP revenues and expenditures in 1982-83, see Canada, Estimates for the Fiscal Year Ending March 31, 1983, Part III, Income Security Expenditure Plan, Health and Welfare Canada (Ottawa: Supply and Services Canada, 1982), pages 42-56, especially page 44. For data on previous fiscal years and for balances in the CPP Account, see Health and Welfare Canada, Canada Pension Plan Statistical Bulletin (Ottawa: Income Security Programs Branch, monthly).

11. Québec, Régie des rentes du Québec. Rapport annuel 1981-82 (Québec: 1982), page 29.

12. Canada, Department of Insurance. Canada Pension Plan Actuarial Report as at December 31, 1977 (Ottawa: 1978).

13. Québec, Régie des rentes du Québec. Analyse actuarielle du Régime de rentes du Québec au 31 décembre 1978 (Québec: 1979).

14. See the explanatory footnote on the bottom of page 12. However the basic relationships illustrated in Figure 2 will remain essentially the same even if "critical year 1" arrives earlier than 1985.

15. Ontario, Ministry of Treasury and Economics. 1982 Ontario Budget, Budget Paper C (Toronto: 1982), page 27.

16. Although few residents of Quebec contribute to the Canada Pension Plan, Quebec is still included in the "two-thirds" amending formula.

17. Royal Commission on the Status of Pensions in Ontario. Report, Volume V, "Ontario and the Canada Pension Plan" (Toronto: Queen's Printer, 1981), Table 6, page 77.

18. As an alternative way of gauging the meaning of a fully funded Canada Pension Plan, we can look at what would happen if the CPP had been put on a fully funded basis from the outset. The contribution rate would have been set at between 7 and 8 percent, more than double the current 3.6 percent. The fund by this time would exceed $200 billion, about ten times the current fund of $21.5 billion.

19. Report of the Ontario Royal Commission, Volume V, page 96.

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